

Franchise Tax Board**ANALYSIS OF ORIGINAL BILL**

Author: Wolk Analyst: Scott McFarlane Bill Number: SB 401
Related Bills: See Legislative History Telephone: 845-6075 Introduced Date: February 26, 2009
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Tax Shelters & Tax-Shelter Penalties

SUMMARY

This bill would eliminate inconsistencies in various abusive tax-shelter laws by providing a single, consistent definition for abusive tax shelters (ATS), which would be referred to as "potentially abusive tax avoidance transactions."

In addition, this bill would modify the ATS-use penalty to no longer allow taxpayers to avoid the penalty by filing an amended return prior to FTB issuing a deficiency notice; instead, this bill would impose 50 percent of the penalty in such situations.

PURPOSE OF THE BILL

The purpose of the bill is to clarify state tax laws that apply to potentially abusive tax avoidance transactions, and to improve the effectiveness of the ATS-use penalty.

EFFECTIVE/OPERATIVE DATE

This bill would be effective January 1, 2010. The operative dates would be as follows:

- The provision relating to interest suspension would be operative for notices mailed or amended returns filed on or after January 1, 2010.
- The provision relating to subpoenas would be operative for subpoenas issued on or after January 1, 2010.
- The provision relating to the eight-year statute of limitations would be operative for taxable years beginning on or after January 1, 2009.
- The provision relating to the ATS-use penalty would be operative for notices mailed on or after January 1, 2010, and for amended returns filed more than 90 days after January 1, 2010, with respect to the taxable years for which the statute of limitations for mailing a notice of proposed assessment has not expired as of January 1, 2010.

POSITION

Pending.

Board Position:			Department Director	Date
<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP		
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ANALYSIS

FEDERAL LAW

Tax Shelters in General

A “tax shelter” is generally a partnership or other entity (such as a corporation or trust), an investment plan or arrangement, or any other plan or arrangement used for the principal purpose of avoiding or evading tax. These transactions generally have no business purpose other than reducing tax; however, a tax shelter is often cloaked in a series of transactions to make it appear to have a business purpose or structured to create an incidental business purpose. Federal Treasury Regulations provide that the principal purpose of an entity, plan or arrangement is to avoid or evade federal income tax if that purpose exceeds any other purpose. Tax-shelter transactions are generally structured with one or more of the following characteristics:¹

- Little or no motive of realization of economic gain;
- Intentional mismatching of income and deductions;
- Overvalued assets or assets with values subject to substantial uncertainty;
- Non-recourse financing and financing techniques that do not conform to standard commercial business practices; and
- Mischaracterization of the substance of the transaction.

Reportable Transactions

A reportable transaction is generally any transaction that has a potential for avoiding or evading tax and the transaction is required to be included a return or statement.² Federal law requires a taxpayer who participated in a reportable transaction to disclose the transaction on an original or amended return for any taxable year the taxpayer participates in the transaction.³ The current categories of reportable transactions include:

- Listed transactions;⁴
- Confidential transactions;⁵
- Transactions with contractual protection;⁶
- Loss transactions;⁷ and
- Transactions of Interest.⁸

¹ IRC section 6662(d)(2)(C) and Treas. Reg. section 1.6662-4(g)(2).

² IRC section 6707A(c)(1).

³ Treas. Reg. section 1.6011-4(a).

⁴ Treas. Reg. section 1.6011-4(b)(2).

⁵ Treas. Reg. section 1.6011-4(b)(3).

⁶ Treas. Reg. section 1.6011-4(b)(4).

⁷ Treas. Reg. section 1.6011-4(b)(5).

⁸ Treas. Reg. section 1.6011-4(b)(6).

Listed Transactions

A listed transaction is a transaction that has been identified by the IRS or the FTB to be a tax-avoidance transaction (i.e. an abusive tax shelter).

Interest Suspension

In general, the IRC requires the payment of interest on any amount of tax imposed that is not paid on or before the last date prescribed for payment of tax.⁹ The IRC precludes taxpayers from filing administrative claims for abatement with respect to income, estate or gift taxes.¹⁰ However, the IRC provides an exception to the general rule under the interest-suspension rule. The interest-suspension rule suspends the accrual of interest and time-sensitive penalties if the Secretary of the Treasury does not provide notice to the taxpayer specifically stating the amount due and the basis for the liability within 36 months of the later of the due date of the return (without regard to extensions) or the date the return is filed.¹¹ The interest-suspension rule does not apply to any interest, penalty, and addition to tax, or additional amount with respect to any undisclosed reportable transaction, listed transaction, or gross misstatement.¹²

Current California Law

SB 614 (Stats. 2003, Ch. 656)¹³ created the following definitions and provisions to curtail the use of abusive tax shelters:

- Potentially Abusive Tax Avoidance Transaction – is defined as any tax shelter or a plan or arrangement which is of a type that the Secretary of the Treasury or the FTB determines by regulation as having a potential for tax avoidance or evasion.
- Eight-Year Statute – if the Franchise Tax Board (FTB) identifies an adjustment relating to an “abusive tax avoidance transaction,” the FTB may notify the taxpayer of a proposed deficiency assessment up to eight years after the taxpayer has filed the return, rather than the normal four-year statute of limitations.
- ATS-Use Penalty¹⁴ – applies if the FTB contacts a taxpayer regarding a deficiency that results from the use of an undisclosed reportable transaction, a listed transaction, or a gross misstatement. The penalty is 100 percent of the interest payable up to the date that a notice of proposed deficiency is mailed.

Because the ATS-use penalty is based on the amount of interest on a deficiency, a taxpayer may avoid the penalty by filing an amended return prior to FTB issuing a deficiency notice.

⁹ IRC section 6601.

¹⁰ IRC section 6404(g).

¹¹ IRC section 6404(g)(1).

¹² IRC section 6404(g)(2).

¹³ R&TC sections 19753, 19755, 19777, and 19116.

¹⁴ R&TC section 19777, often referred to as the 100-percent interest-based penalty.

- Interest Suspension – is a temporary suspension of the imposition of interest and certain penalties if the FTB does not issue a notice within 18 months from the date of a timely-filed return. Interest may not be computed on the additional proposed tax from the day after that 18-month period until 15 days after the notice is issued. This rule does not apply to taxpayers with income greater than \$200,000 and that have been contacted by FTB regarding a "potentially ATS." This provision refers to ATS-use penalty rules for the definition of a "potentially ATS."
- Non-economic Substance Transaction Understatement (NEST) Penalty – is imposed on any understatement attributable to any transaction that lacks economic substance. A "noneconomic substance transaction understatement" is a reportable transaction understatement,¹⁵ or an understatement resulting from the disallowance of any loss, deduction or credit or addition to income that is attributable to a determination that the arrangement lacks economic substance. A transaction is treated as lacking economic substance if the taxpayer does not have a valid nontax business purpose for entering into the transaction.

The penalty is 40 percent of the understatement if the transaction is not disclosed, and is 20 percent if the transaction is adequately disclosed. The penalty applies to the entire amount of the understatement, even if the benefit of the understatement is not recognized on a current-year return. For example, if a taxpayer reports a \$100 million capital loss resulting from a transaction that lacks economic substance, but only utilizes \$10 million of the loss in the current year due to the capital loss limitations, the penalty is based on \$100 million, the total *understated* amount.

AB 115 (Stats. 2005, Ch. 691) modified the tax shelter provisions, and one of the modifications was to the ATS-use penalty. The penalty was changed *from* applying to a deficiency resulting from "any tax shelter or a plan or arrangement which is of a type that the Secretary of the Treasury or the FTB determines by regulation as having a potential for tax avoidance or evasion" to instead apply to a deficiency resulting from "an undisclosed reportable transaction, a listed transaction or a gross misstatement."

THIS BILL

This bill would provide a single, consistent definition for "potentially abusive tax avoidance transactions," which would mean any of the following:

1. A federal tax shelter;
2. An undisclosed reportable transaction;
3. A listed transaction;
4. Any entity, transaction, plan or arrangement that the Secretary of the Treasury or the FTB identifies by regulations, notices, issue papers, or other official public notification as having a potential for tax avoidance or evasion;
5. A gross misstatement; or
6. A transaction subject to the noneconomic substance transaction understatement penalty.

¹⁵ R&TC section 19774(c)(1).

This bill would coordinate this definition of “potentially abusive tax shelters” in the application of:

- The eight-year statute of limitations,
- The ATS-use penalty,
- The interest-suspension rule, and
- The authority to issue subpoenas.¹⁶

In addition, this bill would modify the ATS-use penalty. Current law provides no penalty is imposed if an amended return is filed prior to FTB issuing a deficiency notice. This lessens the effectiveness of the penalty, as most taxpayers file amended returns to avoid the penalty. The penalty would be more effective if taxpayers were instead subject to 50 percent of the penalty by filing an amended return prior to the issuance of a deficiency notice; that way, there would continue to be an incentive to file an amended return and pay the tax, but the most egregious transactions, particularly large-dollar transactions, would still be subject to a significant penalty for having previously reduced tax by the use of abusive transactions.

LEGISLATIVE HISTORY

SB 614 (Stats. 2003, Ch. 656) added and modified ATS definitions and penalties, as explained in the California Law section above.

AB 115 (Stats. 2005, Ch. 691) modified the ATS and penalty statutes.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. (*Florida* imposes corporate income tax, but does not impose personal income tax.)

These states generally follow federal definitions of tax shelters, but the standard for imposing tax-shelter penalties and reporting requirements vary by state. For example, similar to California, Illinois, Minnesota and New York impose penalties on undisclosed reportable transactions; however, the penalty amounts vary by state. No states were found to have an ATS-use penalty similar to California's.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

¹⁶ R&TC section 19504(c)(2). This section refers to the interest-based penalty rules in R&TC section 19777 for the definition of a “potentially abusive tax shelter.”

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed, this bill would result in the following revenue gains beginning in fiscal year 2008/09.

Estimated Revenue Impact of SB 401 Assumed operative on January 1, 2010 Assumed Enacted After June 30, 2009 (\$ in Millions)		
2008/09	2009/10	2010/11
\$3.5	-\$3.6	-\$1.7

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

The revenue is estimated using the following revenue streams:

1. The penalty revenue from expanding the definition of “potentially abusive tax avoidance transactions.”
2. The accelerated revenue from taxpayers that take advantage of the 90-day period to avoid the ATS-use penalty.
3. The revenue decrease due to allowing a 50-percent reduction in the ATS-use penalty.

Estimated Revenue Impact of SB 401 Assumed Operative for Notices Issued On or After January 1, 2010 Assumed Enacted After June 30, 2009 \$ in Millions			
	2008/09	2009/10	2010/11
Stream 1	\$2.5	\$6.3	\$8.8
Streams 2 & 3	\$1.0	-\$9.9	-\$10.5
Total	\$3.5	-\$3.6	-\$1.7

Stream 1:

Revenue from Modifying the Definition of “Potentially Abusive Tax Avoidance Transactions”

Modifying the definition of “potentially abusive tax avoidance transaction” is estimated to increase penalty assessments by \$10 million annually (250 cases X \$40,000). Because this penalty may be protested, the revenue is anticipated to be collected over three years. Assuming that 50 percent of taxpayers protest their penalty assessments, \$5 million (\$10 million X 50%) would be collected during the first year. For fiscal year 09/10, this figure is reduced to \$2.5 million to reflect only assessments issued after January 1, 2010.

Additionally, providing a consistent definition for abusive tax shelters would create departmental efficiencies, potentially reducing the time needed to develop cases at audit and protest levels. These efficiencies would enable staff to pursue additional tax shelter cases. This estimate does not consider revenue gains that may result from these efficiencies.

Streams 2 and 3:

Reducing the ATS-Use Penalty by 50 Percent for Amended Returns & 90-Day Period

Under current law, taxpayers can avoid the ATS-use penalty by filing an amended return after the department has contacted the taxpayer regarding an undisclosed reportable transaction, listed transaction, or gross misstatement, but before FTB issues a deficiency notice. The department currently receives approximately \$17 million annually in revenue from taxpayers that file amended returns to specifically avoid the ATS-use penalty.

It is estimated that because this bill would allow a 50-percent reduction in the penalty in this situation, some taxpayers would continue to file amended returns voluntarily but not at the volume the department currently receives. This portion of the proposal is estimated to result in delayed revenue collections of \$8.5 million (\$17 million X 50%) beginning in fiscal year 10/11. This delayed revenue will be realized in future years when the audits are complete.

Additionally, because the change in law would be operative 90 days after the effective date of the legislation, some taxpayers currently under audit are anticipated to file amended returns during this 90-day period to avoid the ATS-use penalty. In the first year, this portion of the proposal is estimated to accelerate approximately \$5 million from audits that would be in progress, which would have been completed over the next few years.

Revenue Impact Due to the Three Revenue Streams

Because this bill would affect prior tax years, the revenue estimate for each revenue stream has been accrued back one fiscal year. The revenue estimate for fiscal year 2009/10 consists of penalty revenue collection of \$2.5 million (reflected in fiscal year 2008/09). Netting revenue streams two and three results in accelerated payments of \$1 million during the first year and this revenue is accrued back to fiscal year 2008/09.

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